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No. 03-492

IN THE

# Supreme Court of the United States

YVETTE GAFF KLEVEN, Trustee,
MARK A. WARSCO, Trustee, and
DAVID R. DUBOIS, Trustee,
*Petitioners,*

v.

- HOUSEHOLD BANK F.S.B.,
*Respondent.*

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## RESPONDENT'S BRIEF IN OPPOSITION

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## CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6 of the Rules of the Supreme Court of the United States, Respondent respectfully submits this Corporate Disclosure Statement.

The interested parties are Household Finance Corporation, on behalf of named Respondent Household Bank F.S.B.; Household Finance Corporation is a wholly owned subsidiary of Household International, Inc., which is in turn a wholly owned subsidiary of HSBC Holdings plc., a publicly traded company.

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

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## RESPONDENT'S BRIEF IN OPPOSITION

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## STATEMENT OF THE CASE

Petitioners, the Chapter 7 trustees for nearly 100 Debtors, filed adversary proceedings in each Debtor's bankruptcy case seeking to avoid a previous repayment of a loan each Debtor obtained from Respondent Household Bank F.S.B. Petitioners asserted three bases for avoidance, each tailored to a different characterization of the loan. First, Petitioners argued that if repayment of such a loan is a "setoff," each repayment would be avoidable under section 553 of the

Bankruptcy Code. Petitioners next argued that if such a repayment constitutes a "transfer,"[1] the pre-bankruptcy petition repayments would be preferences subject to avoidance under section 547(b) of the Bankruptcy Code, while section 549(a) of the Bankruptcy Code would subject post-bankruptcy petition repayments to avoidance.

The bankruptcy court rejected all three claims. It found that when repayment of a tax refund anticipation loan ("RAL") is considered a setoff, the repayment constitutes a recoupment and thus would not be avoidable by Petitioners. Alternatively, if the RAL repayment is considered a transfer, it nonetheless would be unavoidable because such payments were made in the ordinary course of business and therefore would be exempted from avoidance by section 547(c)(2) of the Bankruptcy Code. The district court affirmed on the same two grounds. The court of appeals affirmed both grounds accepted by the district court and adopted a third argument advanced by Respondent: the Debtors assigned their beneficial interests in the tax refunds to Respondent at the outset of the RAL processes, precluding reliance on any of the avoidance theories propounded by Petitioners.

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[1] The terms "transfer" and "setoff" are, in this context, mutually exclusive. 124 Cong. Rec. 32,393 (1978) (noting the explicit exclusion of the word setoff from the definition of the term transfer and stating that a "'setoff' is not subject to being set aside as a preferential 'transfer' but will be subject to special rules."); *see In re Dillard Ford, Inc.*, 940 F.2d 1507, 1512 (11th Cir. 1991); *Lee v. Schweiker*, 739 F.2d 870, 873 n.4 (3d Cir. 1984); *In re Brooks Farms*, 70 B.R. 368, 372-73 (Bankr. E.D. Wis. 1987); *In re Hinson*, 65 B.R. 675, 677 (Bankr. W.D. Tenn. 1986). A recoupment, like a setoff, is not included within the meaning of transfer. *Reiter v. Cooper*, 507 U.S. 258, 265 n.2 (1993) ("It is well settled, moreover, that a bankruptcy defendant can meet a plaintiff-debtor's claim with a counterclaim arising out of the same transaction, at least to the extent that the defendant merely seeks recoupment. . . . Recoupment permits a determination of the 'just and proper liability on the main issue,' and involves 'no element of preference.'").

Petitioners challenge only the holding that if their claims arise under section 547(b) of the Bankruptcy Code they are defeated by Respondent's ordinary course defense under section 547(c)(2). They do not challenge either of the Seventh Circuit's alternative holdings regarding recoupment and assignment.[2]

Each individual RAL transaction may vary slightly. Respondent and Petitioners agreed to submit the present issues to the bankruptcy court on the basis of a stipulation that reflects the variations in each RAL transaction. *See* Pet. App. E.

As the first step in a Household RAL transaction, the Debtor applies for a RAL from Respondent. *Id.* ¶3(a). The RAL application (the "Application"), signed by the Debtor prior to obtaining the RAL proceeds, provides:

> I acknowledge, understand and agree that . . . my signing of this Application and the IRS Transmittal Form 8453 or Authorization constitutes an irrevocable transfer to [Respondent] of all my rights, title, and interest in the proceeds of my tax refund upon my receipt of, and to the extent of, my RAL obtained this year, and to the extent of any delinquent RALs I received in previous years from [Respondent].

*Id.* exh. A ¶10F & exh. B ¶9F. Respondent creates an account (the "Account") for the sole purpose of receiving the proceeds of the tax refund. *Id.* ¶3(b) & exh. C. The Debtor

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[2] Petitioners suggest but do not argue that the petition should be granted based on a contention that was not raised in the bankruptcy court: RALs are improvident. Pet. at 5. Petitioners do not contend here, and did not argue below, that the RALs at issue are unlawful or otherwise voidable under any of the applicable federal statutes regulating consumer finance. Despite extended *dicta*, the court of appeals recognized that considerations about customers' wisdom in obtaining RALs or the efficacy of the RAL in general are no part of this case. *Kleven v. Household Bank F.S.B.*, 334 F.3d 638, 640 (7th Cir. 2003).

never has access to, or control over, the Account. *Id.* ¶3(h). Respondent retains exclusive possession and control over the Account at all times. *Id.* As part of the application process, the Debtor also completes Form 8453, which irrevocably grants consent to the tax refund being directly deposited into the Account. *Id.* ¶3(c) & exh. D. The Debtor also irrevocably designates the Account for deposit of the tax refund by putting the routing and Account numbers on lines 66(b) and 66(d) of Form 1040. *Id.* exh. C.

Respondent issues the Debtor a check in the amount of her tax refund, less fees, within a few days after receiving the signed Application. *Id.* ¶3(e). Subsequently,[3] the IRS sends Respondent an electronic funds transfer ("EFT") in the amount of the tax refund. *Id.* ¶3(f). Immediately thereafter, Respondent transfers the funds from the Account to an account in its own name. *Id.* ¶3(g). Respondent issues a new check to the Debtor if the tax refund exceeds the Debtor's RAL plus fees.[4]

In all of the cases in this consolidation, the RAL transaction followed the loan documents: after Respondent issued the RAL, it received an EFT from the IRS that covered the RAL amount. Subsequent to and within ninety days of completing the RAL process, the Debtors each filed a Chapter 7 bankruptcy petition. In most cases, Respondent received the EFT from the IRS before the bankruptcy filing; in a few

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[3] The amount of time between the issuance of the RAL and the IRS payment varies depending on when the Debtor picks up her check—the electronic funds transfer from the IRS always comes on the same day of the week. Times varied from four to sixteen days. Pet. App. E exhs. G-K.

[4] Although not common, this occurs when Respondent issues a split RAL—loaning only a portion of the anticipated tax refund. Fewer than ten of the RALs at issue in these cases were split. Where the RAL was split, Petitioners only are seeking to avoid Respondent's retention of funds in the Account equal to the RAL amount, and not the transfer of the excess to the Debtor.

cases, however, Respondent received the EFT from the IRS after the Debtor filed the bankruptcy petition. *Id.* exhs. G-K. At all times relevant hereto, Respondent undertook all activities with respect to the RAL transactions, such as those at issue in this instance, in the ordinary course of Respondent's business or financial affairs and in accordance with the ordinary business terms of the Tax Refund Loan industry. *Id.* ¶8. An overwhelming majority of the Debtors are repeat RAL customers: eighty received RALs from Respondent during at least one previous year and thirty-eight of the eighty received RALs from Respondent for at least three prior tax years.[5] *Id.* exhs. G-K.

## REASONS FOR DENYING THE PETITION

Petitioners' request for a writ of certiorari addresses only one of the court of appeals' three alternative holdings. This is a fatal flaw: either of the two unchallenged alternative holdings adopted by the court below completely disposes of Petitioners' claims, and a reversal of the Seventh Circuit's holding on the sole issue raised by Petitioners would not result in a reversal of the Seventh Circuit's decision. Accordingly, the petition is a wholly inappropriate vehicle for considering the question presented, assuming the question met other cert-worthy requirements.

In addition, Petitioners' basis for seeking certiorari of the Seventh Circuit's holding is Petitioners' claim that there is a split of authority among the Circuit Courts as to the proper method for applying section 547(c)(2)(B) of the Bankruptcy Code. Petitioners specifically assert that the opinion below conflicts with a recent Eighth Circuit decision. A cursory examination of both opinions reveals, however, that there is no conflict between the Seventh Circuit decision and *In re*

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[5] The Debtors' history, if any, with other RAL providers is not in the record, or known to Respondent.

*Armstrong*, 291 F.3d 517 (8th Cir. 2002). Indeed, the *Armstrong* opinion did not address section 547(c)(2)(B)—the section of the Bankruptcy Code upon which the petition here solely is based. Finally, the statutory interpretation advanced by Petitioners is neither supported by *Armstrong*, the only case upon which they rely, nor by the policy underlying the particular provision of the Bankruptcy Code.

## I. THE ALTERNATIVE HOLDINGS BELOW DISPOSE OF THE CASE WITHOUT RECOURSE TO THE PROPOSED QUESTION PRESENTED

Although mostly concerned with Respondent's ordinary course of business affirmative defense, the Seventh Circuit's decision actually included three alternative holdings in Respondent's favor. Only one of the three—that the transfers sought to be avoided fell within the ordinary course of business exception under section 547(c)(2) of the Bankruptcy Code—is the subject of the petition. The Seventh Circuit, as well as the two lower courts, also held that a RAL repayment is an unavoidable recoupment. *Kleven v. Household Bank F.S.B.*, 334 F.3d 638, 643 (7th Cir. 2003) ("The reality of a RAL process, however, is more accurately viewed as a single integrated transaction."); *In re Warsco*, 272 B.R. 246, 253 (Bankr. N.D. Ind. 2002). This holding, which is not challenged by Petitioners, is wholly dispositive of all cases in this consolidation and therefore is sufficient in itself to mandate affirmance of the Seventh Circuit's opinion.[6] The

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[6] Had Petitioners raised this issue, the decisions below would be affirmed. The parties do not dispute that recoupment is recognized by bankruptcy courts and that if a RAL repayment is a "recoupment" it is unavoidable. The dispute focuses solely on whether the repayment, when it is characterized as a credit transaction, constitutes an avoidable "setoff" or an unavoidable "recoupment." Each of the courts below found that a RAL repayment is an unavoidable recoupment. Applying either of the tests to determine whether the obligations arise from the same

Seventh Circuit also ruled on an issue that was argued but not decided in either the bankruptcy court or the district court; the court of appeals held that each Debtor assigned her tax refund to Respondent prior to receiving a RAL, such that, at the time Respondent received the funds from the IRS, Respondent already held title to the tax refund. *Kleven*, 334 F.3d at 643 (Respondent "held title to the funds when they were received at the bank and then transferred to the bank's own account . . . ."). Thus, repayment of a RAL is not a transfer on account of an antecedent debt, and therefore is not avoidable. 11 U.S.C. § 547(b)(2). This holding, which was not raised in the petition, is also completely dispositive of the controversy.[7]

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transaction—*compare In re TLC Hosps., Inc.*, 224 F.3d 1008, 1012 (9th Cir. 2000) (*citing Moore v. New York Cotton Exch.*, 270 U.S. 593, 610 (1926) and adopting a "logical relationship" test) *with In re Univ. Med. Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992) (rejecting logical relationship test and adopting more limited approach)—the courts below found that mutual RAL obligations, if they exist at all, arise from a single integrated transaction. The reasoning is that Respondents extend the RALs, and the Debtors incur the debts, solely in anticipation of repayment by receipt of the tax refunds. The one—granting the loan—is inextricably linked to the other—the debt arising from receipt of the refund into the Account—and both arise from a single contract. *Kleven*, 334 F.3d at 643; *Warsco*, 272 B.R. at 253.

[7] This holding is also correct and thus would not be reversed, even if it fell within the scope of Petitioners' question presented. *See In re Martin*, 167 B.R. 609, 616 (Bankr. D. Or. 1994) (holding transfer unavoidable due to assignment in nearly identical RAL context); *In re Swartz*, 119 B.R. 219 (Bankr. D. Idaho 1990) (same). Delaware law, the law applicable to the RAL documents, provides that an assignment is effective when it manifests the assignor's intent to make a present transfer of the right without further action. *Coca-Cola Bottling Co. of Elizabethtown, Inc. v. Coca-Cola Co.*, 654 F. Supp. 1419, 1440-41 (D. Del. 1987). Every aspect of the RAL transaction manifests an intentional and effective assignment to Respondent of Debtor's beneficial interest in the tax refund; each Debtor took all steps necessary to unconditionally grant possession of

The significance of the alternative holdings in the courts below cannot be overstated. Unlike the holding that the ordinary course of business defense precludes recovery under Petitioners' preferential transfer claims—which could not defeat the avoidance of post-petition transfers—the recoupment and assignment holdings apply to each and every one of the cases in the consolidation. Petitioners take no exception from either holding. Thus, even if this Court were to agree that the courts below erred in their application of the ordinary course of business defense to the facts of these cases, the Court would nevertheless affirm the judgments below based on the two alternative holdings. Therefore, the Petition for Writ of Certiorari should be denied.

## II. THERE IS NO CIRCUIT SPLIT—THE RULING BELOW DOES NOT CONFLICT WITH *IN RE ARMSTRONG*

Even if the Court concludes that the issue presented by Petitioners is relevant and potentially case-dispositive, it should nonetheless deny the petition. The only basis raised by Petitioners for review of the opinion below is that there is an alleged split of authority between the Circuit Courts regarding application of the ordinary course of business defense set forth in section 547(c)(2). There is no such split.

Petitioners assert that the Seventh Circuit based its opinion on an "assum[ption] that the transaction is 'ordinary' for each of the individual Debtors, even without the benefit of facts relating to the treatment the Debtors afford their other creditors." Pet. at 7. Petitioners then claim that the Eighth Circuit, in *In re Armstrong*, "held that the 'ordinary course of business' defense in a consumer transaction requires evidence that the transaction is 'within the ordinary course of the

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their income tax refund proceeds to Respondent at the time of the RAL application.

debtor's financial affairs.'" *Id.* The "split," therefore, is the alleged failure of the Seventh Circuit to require a factual finding of "ordinary" on the part of the Debtors in the present case, a finding that the Eighth Circuit required. Petitioners misread the opinion below. The Seventh Circuit did make a factual finding that the transactions were ordinary as to the Debtors, in accordance with well-established tests of "ordinary."[8] *Kleven*, 334 F.3d at 642.

There are three separate prongs to the ordinary course of business defense. Section 547(c)(2) of the Bankruptcy Code shields a transfer from avoidance if the following three elements are met: the transfer (A) was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) was made in the ordinary course of business or financial affairs of the debtor and the transferee; and (C) was made according to ordinary business terms. 11 U.S.C. § 547(c)(2)(A)-(C). Only paragraph (B) is at issue in the petition. Pet. at 3, 5.

The *Armstrong* court applied only paragraph (A), finding that because the requirements of that paragraph were not met, the court did not have to reach paragraphs (B) or (C). *In re Armstrong*, 291 F.3d at 527-28. *Armstrong* therefore is not relevant to the question presented in this case. Further, nothing about the *Armstrong* opinion conflicts with the decisions below. In applying Section 547(c)(2)(A), the *Armstrong* court first discussed the "policy background framing the ordinary business exception," namely "(1) to encourage creditors to continue dealing with troubled debtors, and (2) to promote equality of distribution." *Id.* (citing *Union Bank v. Wolas (In re ZZZZ Best Co.)*, 502 U.S. 151, 161 (1991)). Here, the Seventh Circuit likewise recognized the

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[8] Petitioners disagree with the Seventh Circuit's application of the tests for "ordinary" to the facts present, but this is insufficient basis for this Court to accept review. SUP. CT. R. 10.

two purposes for the exception to the Trustees' avoidance power. *Kleven*, 334 F.3d at 641 ("The purpose of this section is two-fold. It is designed to promote equality of distribution among all creditors while simultaneously it deters creditors from 'racing to the courthouse to dismember the debtor during [his] slide into bankruptcy.'") (quoting *Wolas*, 502 U.S. at 161). The Eighth Circuit then reviewed the facts of the case, in light of the purposes of the exception. The *Armstrong* case involved the incurrence of gambling debt by a man who was gambling in a desperate attempt to hide substantial losses caused by his illegal activity. The court easily concluded that the gambling debt was not incurred in the debtor's ordinary course of business:

> That Armstrong was not a professional gambler is certainly a probative fact to take into account in assessing whether or not the transaction was within his ordinary business affairs, but it is not dispositive. More important here is that Armstrong's purpose for gambling, other than entertainment, was to cover huge losses arising from Armstrong's fraud, embezzlement, and Ponzi schemes. . . . We decline to hold that a desperate debtor's irresponsible accumulation of gambling debts in an ill-fated attempt to cover fraud and embezzlement losses qualifies as the ordinary course of his business or financial affairs.

*In re Armstrong*, 291 F.3d at 527.

The Seventh Circuit likewise made a factual inquiry, and concluded that the Debtors incurred the debts in the ordinary course of business. *Kleven*, 334 F.3d at 642-43. Unlike significant gambling debt incurred by someone, who is not a professional gambler, in a last-ditch effort to avoid discovery of an illegal Ponzi scheme, the Debtors in the present cases took out refund anticipation loans that are taken out by "millions of people." *Id.* at 639.

There is simply no split in authority: the Seventh and Eighth Circuits both require a factual showing that the debtor incurred the debt in the ordinary course of the debtor's business. Both circuits reviewed the record in light of the purposes of the preference statute, determining whether the payments were "ordinary" or whether there was undue pressure or other unusual circumstances. The Seventh Circuit did not apply a novel or unusual legal standard, but rather examined the facts of this case in light of established jurisprudence applying the preference statute. As there is no split between the Circuit Courts regarding application of the ordinary course of business defense, Petitioners fail to demonstrate a need for review by this Court.

## III. PETITIONERS' PROPOSED METHOD FOR APPLYING SECTION 547(C)(2) IS INCONSISTENT WITH CASE LAW AND THE STATUTE

This Court should also deny review of the Seventh Circuit's opinion because Petitioners' proposed method for applying section 547(c)(2)(B) is inappropriate. The determination of "ordinariness" under section 547(c)(2)(B) is fact specific. If there is a prior relationship between debtor and creditor, the court examines that relationship to judge what is ordinary. *See In re Gulf City Seafoods, Inc.*, 296 F.3d 363, 368 n.4 (5th Cir. 2002); *In re Midway Airlines, Inc.*, 69 F.3d 792, 797-98 (7th Cir. 1995); *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494, 497 (8th Cir. 1991). When there is no prior relationship between the parties, the court examines whether the "transaction would not be out of the ordinary for a person in the borrower's position." *In re Finn*, 909 F.2d 903, 908 (6th Cir. 1990). All three courts below applied these well established tests. Instead of those standards, Petitioners assert, without citing any direct authority,[9] that a court, when

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[9] Petitioners cite only *Armstrong*, but it provides no support for their position.

determining what constitutes "ordinary course," should compare the types of debt and methods of payment a debtor engaged in with other creditors. Pet. at 7.

Further, Petitioners' proposed test not only is unsupported, but is inconsistent with the statutory scheme. First, the language of the statute does not support Petitioners' argument. Section 547(c)(2)(A), provides that the transfer must be "incurred by the debtor in the ordinary course of business or financial affairs of the debtor *and* the transferee." 11 U.S.C. § 547(c)(2)(A) (emphasis added). Section 547(c)(2)(B) provides that the transfer must be "made in the ordinary course of business or financial affairs of the debtor *and* the transferee." 11 U.S.C. § 547(c)(2)(B) (emphasis added). Thus, section 547(c)(2)(A) and (B) focuses on the relationship between the *debtor and the transferee* and not on the debtor's relationship with third parties.

In addition to being inconsistent with the statute and the case law, the rigid test proposed by Petitioners, particularly in the context of a first-time RAL transaction, is contrary to sound bankruptcy policy. The goal of the ordinary course of business defense is to leave undisturbed normal commercial and financial relationships and protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business of both the debtor and the debtor's transferee. *In re Midway Airlines*, 69 F.3d at 797; *In re Classic Drywall, Inc.*, 121 B.R. 69, 75 (D. Kan. 1990); H.R. Rep. No. 95-595, at 177-78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138; S. Rep. No. 95-989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874. As noted in the courts below, the rationale of this policy is, among other things, to encourage creditors to continue to do business with potential debtors and to discourage creditors from racing to the courthouse to dismember the debtor during her slide into bankruptcy. *See Union Bank v. Wolas, (In re ZZZZ Best Co.)*, 502 U.S. 151, 161 (1991); *Advo-System, Inc. v. Maxway*

*Corp.*, 37 F.3d 1044, 1047 (4th Cir. 1994); *In re Air South Airlines*, 247 B.R. 165, 170 (Bankr. D.S.C. 2000).

These policy goals would be ill served by adopting the test proposed by Petitioners. To begin, it is unthinkable that a creditor who contracts with a consumer debtor and gets paid in accordance with both the contract and industry terms should *ever* have a problem establishing the ordinary course of business defense and, in such cases, the law should be construed so as to discourage such suits. Second, it would be very difficult and costly for creditors to apply and prove the test, as it would require extensive analysis of a debtor's dealings with third parties. Third, it would impose a *per se* rule completely preventing creditors from establishing the defense against a claim that would be typical for numerous consumers but is asserted by an individual consumer who enters into that type of debt infrequently. For example, under Petitioners' test, a phone company would be precluded from establishing the ordinary course of business defense against any debtor who sets up an automatic deduction for payment of her phone bill but pays all other bills by check. Fourth, even if the debtor transacted business with other similarly situated creditors, there is no valid reason why *those* relationships must determine whether a transaction *between the debtor and the creditor* was ordinary. In sum, adoption of Petitioners' test would eviscerate the ordinary course of business defense and, in so doing, discourage creditors from extending credit to parties on the verge of bankruptcy.

## CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

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